

## Message Text

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ACTION EUR-12

INFO OCT-01 ISO-00 AID-05 CIAE-00 COME-00 EB-07 FRB-03  
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R 101209Z JUN 77  
FM AMCONSUL MILAN  
TO SECSTATE WASHDC 5431  
TREASDEPT WASHDC  
INFO AMEMBASSY ROME  
AMEMBASSY BONN  
AMEMBASSY BRUSSELS  
AMEMBASSY LONDON  
AMEMBASSY PARIS

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PARIS FOR OECD BRUSSELS FOR OECD

EMBASSIES PLEASE POUCH TO ALL CONSULATES

E.O. 11652: N/A  
TAGS: EFIN, IT  
SUBJECT: VIEWS OF MILANESE BANKERS ON ECONOMIC SITUATION

1. SUMMARY. FOLLOWING ARE MAIN POINTS WHICH EMERGED  
FROM TREASATT VISIT TO MILAN BANKS (8 AMERICAN AND 6  
ITALIAN) ON JUNE 7-9: (1) LIRE EXCHANGE RATE WILL  
BE STABLE THROUGH SEPTEMBER AFTER WHICH, IF IT  
WEAKENS, DEPRECIATION WILL LIKELY BE SLIGHT AND  
WELL CONTROLLED; (2) ITALIAN EXPORT PRICES ARE  
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STILL COMPETITIVE DEPSITE RECENT PRICE AND COST  
INFLATION BUT EXPORT CREDIT IS A PROBLEM AND THERE  
IS NEED TO CHANGE COMPOSITION OF EXPORTS IN LONGER  
RUN (3) INCREASE IN SHORT-TERM FOREIGN DEBT OF  
ITALIAN COMMERCIAL BANKS HAS ALREADY BEGUN TO TAPER  
OFF; SUCH DEBT IS RELATIVELY RISK-FREE TO FOREIGN  
LENDERS SINCE IT HAS LARGELY BEEN USED TO FINANCE

ADVANCE SURRENDER OF EXPORT RECEIPTS; (4) MODEST AMOUNT OF ADDITIONAL EUROMARKET TERM LOANS TO ITALIAN BORROWERS IS POSSIBLE LATER THIS YEAR FOLLOWING RECENT IMI CREDIT BUT ON HIGHLY SELECTIVE BASIS; (5) LARGE SCALE CAPITAL FLIGHT MAY BE THING OF THE PAST DUE TO 1976 CRIMINAL PENALTY LAW; (6) INVESTMENT PROSPECTS ARE NOT VERY GOOD BUT RELATIVELY BETTER FOR EQUIPMENT MODERNIZATION IN SMALL AND MEDIUM BUSINESS THAN ELSEWHERE; (7) RESTRUCTURING OF FINANCES OF BUSINESS SECTOR IS NEEDED BUT USEFUL GOI ACTION IS BY NO MEANS CERTAIN; (8) CONSUMPTION DEMAND IS APPARENTLY TAPERING OFF IN SECOND QUARTER WHILE LABOR RELATIONS ARE IMPROVED; AND (9) BANKERS SEEM TO HAVE PAID LITTLE ATTENTION TO POLITICAL PARTIES' EFFORTS IN ROME TO DRAFT ECONOMIC POLICY MEASURES AS PART OF "PROGRAMATIC ACCORD." END SUMMARY.

2. THE LIRA. THERE WAS UNANIMOUS AGREEMENT AMONG MILANESE BANKERS THAT LIRA/DOLLAR EXCHANGE RATE WILL REMAIN STABLE AT LEAST THROUGH AUGUST AND PROBABLY THROUGH SEPTEMBER DUE IN PART TO FAVORABLE SEASONAL FACTORS. SEVERAL BANKERS SAID THAT ITALIAN CLIENTS WHO HAD BORROWED FOREIGN CURRENCY ABROAD HAD DONE SO WITHOUT SEEKING FORWARD COVER, BUT THAT SOME PLANNED TO ASK FOR COVER FOR LOANS FALLING DUE AFTER AUGUST OR SEPTEMBER. FEW BANKERS WERE WILLING TO HAZARD A GUESS ABOUT LIRA PERFORMANCE IN LAST QUARTER OF YEAR AND BEYOND. ONE LIMITED OFFICIAL USE

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THOUGHT DOLLAR RATE MIGHT DEPRECIATE IN RANGE 900-950 LIRE PER DOLLAR. ANOTHER SAID THAT SEASONALLY WEAK PERIOD (OCTOBER 1977 TO MARCH 1978) WOULD PROVIDE IMPORTANT TEST FOR LIRA STABILITY. AN AMERICAN BANKER SPECULATED THAT GOI HAS INTERVENED IN FORWARD MARKET IN ORDER TO STRENGTHEN CONFIDENCE IN LIRA LATER THIS YEAR. SEVERAL BANKERS CITED SOME FAVORABLE FACTORS WHICH MIGHT ALLOW LIRA TO REMAIN STABLE EVEN AFTER SUMMER PERIOD, I.E., AND EXPECTED SLOWDOWN IN PRODUCTION AND IMPORTS, CONTINUED STRONG TOURIST ACCOUNT AND ABILITY AND DETERMINATION OF BANK OF ITALY (BOI) TO PROVIDE MODEST SUPPORT THROUGH INTERVENTION.

3. EXPORT PROSPECTS. ALL BANKERS AGREED THAT ITALIAN EXPORTERS STILL HAVE PRICE MARGIN FROM 1976 DEPRECIATION OF LIRA WHICH ALLOWS ITALIAN PRODUCTS TO BE PRICE-COMPETITIVE. HOWEVER, MOST THOUGHT THAT MARGIN WAS NOW FAIRLY SMALL. LIRA

DEPRECIATION HAD "BOUGHT TIME" TO ALLOW ITALIAN ECONOMY TO MAKE SOME STRUCTURAL ADJUSTMENTS. TWO BANKERS CITED HIGH DOMESTIC INTEREST RATES AND SLOW OFFICIAL EXPORT CREDIT AND GUARANTEE PROCEDURES AS IMPEDIMENTS. THEY WERE ENCOURAGED BY NEW OSSOLA EXPORT CREDIT LOAN BUT TOOK "WAIT AND SEE" ATTITUDE ABOUT WHETHER ITS IMPLEMENTATION WOULD REALLY BRING ABOUT DESIRE SPEEDING IN ADMINISTRATIVE PROCEDURES. UNLESS DOMESTIC INFLATION WAS REDUCED TO PERMIT DECLINE IN INTERNAL INTEREST RATES ITALY WOULD STILL BE HANDICAPPED IN GRANTING EXPORT CREDIT TERMS ON A PAR WITH ITS COMPETITORS. ONE BANKER THOUGHT THAT RECENT SHARP RISE IN ITALIAN BANKS' SHORT-TERM FOREIGN DEBT (WHICH HAS BEEN USED LARGELY TO FINANCE EXPORTERS' 50 PERCENT ADVANCE FOREIGN EXCHANGE SURRENDER REQUIREMENT FOR EXPORTS SOLD ON CREDIT) MAY HAVE HELPED TO INTRODUCE SOME LIMITED OFFICIAL USE

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NEW ITALIAN EXPORTERS INTO WORLD MARKETS. HE ALSO FAVORED FORMATION OF CONSORTIA OF SMALL AND MEDIUM SIZED EXPORT FIRMS ESPECIALLY TO ALLOW THEM TO COMPETE ON LARGE "TURN KEY" PROJECTS ABROAD. ANOTHER BANKER FORESAW FAIRLY STRONG DEMAND FOR ITALIAN EXPORTS OF CAPITAL GOODS AS BUSINESS CYCLE ABROAD LED TO NEED FOR ADDITIONAL INVESTMENT.

4. FOREIGN DEBT OF ITALIAN COMMERCIAL BANKS. BANKERS WERE ALL KEENLY ATTUNED TO RECENT PUBLIC DEBATE ABOUT LARGE ACCUMULATION OF SHORT-TERM FOREIGN DEBT BY ITALIAN BANKS. SEVERAL JUSTIFIED SUCH DEBT ON GROUNDS THAT BANKS WERE USING FOREIGN LOANS IN LARGE PART TO FINANCE 50 PERCENT ADVANCE SURRENDER OF EXPORT PROCEEDS ON CERTAIN CREDIT SALES WHICH HAS BEEN REQUIRED UNDER CURRENT FOREIGN EXCHANGE REGULATIONS. SINCE LOANS WERE TIED TO IDENTIFIABLE FUTURE FOREIGN EXCHANGE RECEIPTS THESE BANKERS THOUGHT THAT RISK WAS SMALL FOR THEM AND FOR ITALY. ONE (LIKE BOI GOVERNOR BOFFI IN SPEECH AT ANNUAL MEETING) ARGUED THAT AS LONG AS INTEREST RATE DIFFERENTIAL AND STALE LIRA FAVORED SUCH CAPITAL INFLOWS THERE WAS NO GREAT CAUSE FOR CONCERN. SEVERAL BANKERS ACCUSED INEXPERIENCED MIDDLE SIZED ITALIAN BANKS OF HAVING DISTURBED MARKET FOR SUCH LOANS BY PRESSING TOO HARD FOR FUNDS AND BY PAYING TOO MUCH FOR THEM, WHICH HURT CREDIT RATING OF OTHER BANKS. ONE BANKER SAID THAT, IF DEBT REPAYMENT EVER BECAME A PROBLEM FOR ITALY, SUCH SHORT-TERM TRADE CREDITS WOULD BE MORE LIKELY TO RECEIVE PREFERENCE FROM ITALIAN MONETARY AUTHORITIES THAN

WOULD EITHER OUTSTANDING EUROMARKET OR OFFICIAL  
BALANCE OF PAYMENTS LOANS. ANOTHER BANKER SUGGESTED  
THAT, TO SOME EXTENT, FOREIGN BANK CREDIT WAS BEING  
USED TO REPAY FOREIGN SUPPLIER CREDITS, SINCE THERE  
HAD BEEN A LAG IN AWARENESS OF ITALY'S BALANCE OF  
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PAYMENTS PROBLEMS ON PART OF FOREIGN SUPPLIERS.

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THUS, TOTAL OF THESE TWO KINDS OF DEBT HAD RISEN  
LESS THAN IT APPEARED. ALSO, WHEN RECENT  
AND EXPECTED BALANCE OF PAYMENTS IMPROVEMENT BECAUSE  
KNOWN TO FOREIGN SUPPLIERS, THEY MIGHT AGAIN OFFER  
BETTER TERMS, PERMITTING ITALY TO REDUCE ITS NEED  
FOR FOREIGN BANK CREDIT. NONETHELESS, THERE WAS  
NEAR UNANIMITY THAT ITALIAN BANKS' SHORT-TERM FOREIGN  
DEBT SHOULD NOT BE ALLOWED TO INCREASE MUCH MORE.  
IN FACT, SOME AMERICAN BANKERS SAID THAT RISE IN

SUCH DEBT HAD ALREADY STOPPED ABOUT TWO WEEKS AGO.  
TO SOME EXTENT ITALIAN BANKS THEMSELVES,SWHICH  
WERE BETTER AWARE OF SIZE OF TOTAL EXPOSURE THAN  
BEFORE, WERE MORE CAUTIOUS IN SEEKING ADDITIONAL  
CREDIT. AMERICAN BANKERS SUSPECTED THAT MONETARY  
AUTHORITIES WOULD SOON PLACE SOME LIMIT ON FURTHER  
BORROWING, EITHER BY DIRECT ACTION ON BANKS' NET  
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FOREIGN DEBT POSITION OR INDIRECTLY BY LIMITATION  
ON CREDITS IN FOREIGN EXCHANGE GRANTED BY BANKS  
TO THEIR RESIDENT CLIENTS. IN FIRST CASE SOME BANKS  
MIGHT TRY TO BORROW ADDITIONAL FUNDS NOW IN ORDER  
TO RAISE THEIR HISTORIC BASE IN ANTICIPATION OF  
IMPOSITION OF LIMIT. ON OTHER HAND, SOME ITALIAN  
BANKERS IMPLIED THAT BOI HAD ALREADY USED MORAL  
SUASION TO LIMIT FURTHER INCREASES IN DEBT AND,  
ONLY IF THAT DID NOT WORK, MIGHT ADMINISTRATIVE  
ACTION BE NECESSARY. (ON LAST DAY OF VISIT GOI  
REDUCED 50 PERCENT ADVANCE EXPORT SURRENDER REQUIREMENT  
TO 25 PERCENT. PRESS REPORTS SUGGEST THIS WILL REDUCE  
EXPORTERS' DEMAND FOR FOREIGN CREDIT BY \$500-  
1000 MILLION IN COMING MONTHS.)

6. EUROMARKET TERM LOANS. AMERICAN BANKERS TOOK  
CAUTIOUS APPROACH TO RECENTLY ANNOUNCED \$200  
MILLION EUROMARKET TERM LOAN TO ITALIAN SPECIAL  
CREDIT INSTITUTE IMI. REPRESENTATIVE OF ONE OF  
BANKS WHICH IS PARTICIPATING IN CONSORTIA SAID THAT  
INITIATIVE FOR CREDIT HAD COME FROM IMI ITSELF AND  
NOT FROM ITALIAN MONETARY AUTHORITIES. BANKS IN  
CONSORTIA WERE STRESSING THAT LOAN WAS DESIGNED TO  
PROVIDE FUNDS FOR IMI'S EXPORT CREDIT ACTIVITIES  
AND WAS NOT A BALANCE OF PAYMENTS COMPENSATORY LOAN  
LIKE THOSE OF 1972-74. THERE SEEMED TO BE SOME  
AGREEMENT THAT ADDITIONAL TERM LOANS MIGHT BE POS-  
SIBLE THIS YEAR, BUT NOT IMMEDIATELY AND ON A  
SELECTIVE BASIS BOTH AS TO BORROWER AND AS TO USE  
OF PROCEEDS. ONE BANKER THOUGHT THAT ITALIAN POLITICAL  
DEVELOPMENTS WOULD INFLUENCE LOAN PROSPECTS AND WAS  
CONCERNED THAT RECENT LAW DESIGNED TO LIQUIDATE  
STATE HOLDING COMPANY ENAM WHICH INVOLVED PARTIAL  
LOAN DEFAULTS BY GOVERNMENT BODY COULD HURT ITALY'S  
INTERNATIONAL CREDIT RATING.

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7. CAPITAL FLIGHT. ALL BANKERS WHO COMMENTED ON PERPETUAL ITALIAN PROBLEM OF ILLEGAL CAPITAL FLIGHT WERE CONVINCED THAT 1976 CRIMINAL PENALTY LAW (WHICH ALSO ASSESSES CRIMINAL PENALTIES ON BANK EMPLOYEES WHO ARE ACCOMPLICES IN SUCH CAPITAL FLIGHT) IS SERIOUS DETERRENT TO CONTINUED LARGE SCALE ILLEGAL CAPITAL OUTFLOW. WHILE ECONOMIC AND POLITICAL CONDITIONS DO NOT NOW FAVOR CAPITAL FLIGHT, BANKERS BELIEVED THAT, WHEN PUT TO THE TEST, LAW WOULD STILL BE QUITE EFFECTIVE. OLD DAYS WHEN BANK EMPLOYEES ASSISTED IN CONCEALED CAPITAL OUTFLOW JUST TO PLEASE THEIR CLIENTS WERE OVER. THUS, SUCH WIDE-SPREAD PHENOMENON MAY BE A THING OF THE PAST, EVEN IF SOME MODEST OUTFLOW PERSISTS. IF SO, BANKERS THOUGHT THIS WAS IMPORTANT AND FAVORABLE NEWS FOR ITALIAN BALANCE OF PAYMENTS.

8. DOMESTIC CREDIT CONDITIONS. THERE WAS FAIRLY EVEN SPLIT IN VIEWS CONCERNING STRENGTH OF DOMESTIC CREDIT DEMAND. ON BALANCE IT SEEMED TO BE VIEWED AS MODERATE. STRUCTURE OF DEMAND AND SUPPLY HAD BEEN SHIFTED BY RE-INTRODUCTION OF QUANTITATIVE BANK CREDIT CEILINGS ON LIRA LOANS, AT SAME TIME THAT EXCHANGE RATE, EXCHANGE CONTROLS AND INTEREST RATE DIFFERENTIALS FAVORED RESORT TO FOREIGN CREDIT. ALL BANKERS FORESAW EITHER STABILITY IN LEVEL OF INTEREST RATES OR, MORE LIKELY, SOME FURTHER MODEST DECLINE, ESPECIALLY IF ECONOMIC DECELERATION IN RATE OF INFLATION CONTINUED. HOWEVER, THEY BELIEVED THAT MONETARY AUTHORITIES WERE IN NO HURRY TO ALLOW ANY DROP IN INTEREST RATES WHICH MIGHT REVERSE INCENTIVE TO CAPITAL INFLOW OR DISCOURAGE SAVINGS.

9. INVESTMENT PROSPECTS. SINCE MOST BANKS VISITED WERE COMMERCIAL BANKS INVOLVED MAINLY IN SHORT-TERM LENDING, THEIR KNOWLEDGE OF INVESTMENT PROSPECTS LIMITED OFFICIAL USE

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WEAS LIMITED. HOWEVER, THERE WAS GENERAL AGREEMENT THAT INVESTMENT IN PLANT EXPANSION WAS RARE NOW BECAUSE OF EXCESS CAPACITY, POLITICAL AND ECONOMIC UNCERTAINTIES AND UNWILLINGNESS TO PAY PRESENT HIGH NOMINAL INTEREST RATES OVER LONG TERM. VIEWS WERE MIXED CONCERNING AMOUNT OF EQUIPMENT MODERNIZATION GOING ON, WITH BELIEF THAT IN SMALL AND MEDIUM SIZED INDUSTRY THERE WAS SOME INVESTMENT GOING ON "IN SPITE OF EVERYTHING."

10. FINANCIAL RESTRUCTURING OF BUSINESS. BANKERS

DID NOT SEEM TERRIBLY IMPRESSED WITH RECENT PROPOSALS TO IMPROVE FINANCIAL STRUCTURE OF ITALIAN BUSINESS, ESPECIALLY THROUGH INCENTIVES TO ACCUMULATION OF EQUITY CAPITAL. SOME SEEMED TO THINK THAT MAIN EFFORT WOULD SIMPLY BE TO BAIL OUT LARGE STATE-OWNED COMPANIES IN DIFFICULTY. THERE WAS SOME FAVORABLE COMMENT ON MINFIN PANDOLFI'S PROPOSAL FOR ELIMINATION OF DOUBLE TAXATION OF DIVIDENDS. BUT BANKERS THOUGHT THAT BROADER MEASURES WERE NEEDED, ESPECIALLY RESTORATION OF PROFITS. BANKER FROM ONE LARGE ITALIAN BANK FAVORED SOME FINANCIAL RESTRUCTURING EFFORT BUT ARGUED THAT DIFFERENT MEASURES WOULD BE REQUIRED DEPENDING ON SIZE OF BUSINESS, I.E., LARGE BUSINESSES WERE OVERBURDENED WITH LONG-TERM DEBT AND SMALLER BUSINESSES WITH SHORT-TERM DEBT. AN INVESTMENT BANKER FAVORED CUT IN CORPORATE TAX BURDEN AS BEST WAY TO CREATE INTERNALLY GENERATED EQUITY INVESTMENT FUNDS.

11. PRODUCTION, CONSUMPTION, LABOR RELATIONS. BANKERS DID NOT CLAIM TO BE EXPERTS ON THESE ASPECTS OF REAL ECONOMY. MORE THAN ONE BANKER DID SAY THAT THERE SEEMED TO HAVE BEEN A DECELERATION OF CONSUMER DEMAND SINCE APRIL. OTHER BANKER THOUGHT THAT ITALIAN BUSINESSMEN WERE FOLLOWING MORE CAUTIOUS LIMITED OFFICIAL USE

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INVENTORY POLICIES THAN DURING 1974-75 BUSINESS CYCLE SO THAT VOLATILITY OF INVENTORY CHANGES HAS LESSENED. ONE BANKER CLAIMED THAT, FOLLOWING RELATIVELY LOW INDUSTRIAL PRODUCTION INDEX IN APRIL, EVIDENCE IN MILAN SUGGESTED THAT THERE HAD BEEN SOME RECOVERY IN MAY. THERE WAS MODERATE OPTIMISM ABOUT OVERALL IMPROVEMENT IN LABOR-MANAGEMENT RELATIONS DURING RECENT MONTHS. HOWEVER, THERE WAS SKEPTICISM ABOUT ABILITY OF LABOR LEADERS TO PERSUADE LABOR BASE TO ACCEPT FURTHER SACRIFICES. THERE WERE MIXED VIEWS AS TO WHETHER OR NOT LABOR LEADERS' COMMITMENT TO LIMIT WAGE DEMANDS IN COMPANY LEVEL BARGAINING WOULD BE RESPECTED.

12. "PROGRAMATIC ACCORD". RECENT EFFORTS OF POLITICAL PARTIES IN ROME TO FORMULATE "PROGRAMATIC ACCORD", INCLUDING SOME ECONOMIC POLICY CONTENT, DID NOT SEEM TO HAVE ATTRACTED MUCH ATTENTION IN MILANESE BANKING COMMUNITY. ONE BANKER HOPED THAT SOME KIND OF "SOCIAL PACT" AMONG BUSINESS, LABOR AND GOVERNMENT WOULD EMERGE, BUT HE WAS NOT PARTICULARLY OPTIMISTIC. ANOTHER THOUGHT THAT SOMETHING MIGHT BE DONE TO GET BUDGET EXPENDITURES UNDER BETTER CONTROL, BUT PROS-

PECTS FOR FURTHER ACTION ON LABOR COST PROBLEMS  
WERE NOO VERY GOOD. ANOTHER BANKER TOOK THE OPPOSITE  
VIEW ABOUT THE RELATIVE PROSPECTS OF DEALING WITH  
BUDGET DEFICIT AND LABOR COST PROBLEMS.FINA

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